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TRADING

MULTILATERAL, MULTI-ITEM TRADES POSSIBLE THOUGH *NET EXCHANGE*

Whether in finance, science, scheduling logistics, or almost any marketplace imaginable, an electronic matching system developed by ***Net Exchange***, a leader in computational marketplace design, has emerged to address a time-worn economic problem. From the liquid world of securities, bandwidth, or electric power trading, market participants face a dilemma: among the many items they might wish to ***exchange*** at a given time, markets have traditionally limited them essentially to single-item, bilateral transactions--one transaction at a time with one counterparty. But what would be the effect on trade and prices if there were a market mechanism in place that facilitated simultaneous multi lateral, multi-item transactions?

Net Exchange, the brainchild of noted CalTech economist John Ledyard, has led the development and marketing of numerous "combined value" trading mechanisms since the early 90s, whose scope has multiplied with the advent of the Internet. Some of these, such as Bond Connect, an electronic bond-trading system operated by State ***Street*** Bank on a ***technology*** platform licensed from ***Net Exchange***, facilitate multilateral, multi-item portfolio management of items commonly traded in secondary markets, such as bonds or other financial instruments. However, ***Net Exchange's*** greater innovation lies in the construction of platforms which actually create and support marketplaces to trade items not heretofore securitized -- such as outsourced national trucking lanes for the Sears network or resource allocations between scientific instrument teams competing for scarce resources aboard NASA's space science missions.

The ***Net Exchange*** credo rests upon the simple but far-reaching premise that if one defines a set of transactions involving, say, a dozen items and several dozen participants, none of whom cares about more than one subset of the items, the greatest liquidity can be found among the whole transaction set and not in any particular bilateral transaction. Marketplaces embodying this credo can be limited to primary issue (e.g. procurement), or expanded to include secondary trading.

Debuting in June to positive reviews as it drew in 80 participating institutions over six weeks, Bond Connect is a forerunner to other systems ***Net Exchange*** hopes to mount in strategic hot spots, such as the opening trading bell on Nasdaq or the NYSE.

"If an individual trade's value depends on the outcome of other trades," says Charles Polk, principal of ***Net Exchange***, "then the investor has combinatorial values to which a trading system should cater. Most systems other than Bond Connect do not address the opportunity costs of overlooking the combinatorial nature of portfolio transactions." If investors knew they could complete the multiple legs of their portfolio transactions simultaneously, Polk adds, they would be willing to bid more and ask less for each because they would no longer have to hedge their offers pending uncertainty over subsequent trades. In effect, the combinatorial system increases liquidity by decreasing the trading risk associated with partial execution, while facilitating multilateral ***exchanges***. "Portfolio managers have analytics that allow them to translate what they have into what they want, but that is always multi-dimensional," Polk elaborates. "It is never just one thing."

"For example, a bond trader adjusting his portfolio for characteristics like duration or credit quality might typically need five serial transactions," explains Donna Beck, vice president of marketing at State ***Street***. Bond Connect helps minimize the risk of unbalanced executions. Furthermore, Bond Connect allows users to express the substitutability of bonds with similar attributes--sector, credit quality, duration, or coupon--which frequently are of more importance than the particular issue. Such substitutability allows managers trading auto receivable bonds to Ford Motor Credit or GMAC bonds interchangeably. All in all, this ***technology*** more closely aligns financial analysis with transaction execution.

"A key aim of ***Net Exchange***," says Charles Polk, "is to extend practices common in financial or agricultural sectors, such as forwards and futures, to goods not previously considered standard enough to do that." Such goods could be exotic or the standard "primary issue" of ordinary physical commerce--foodstuffs, chemicals, etc. "***Net Exchange*** creates marketplaces that embed primary issue in secondary markets. We do not care if those attributes are a piece of debt, time, location, volume or service pertaining to physical commerce. They are just parameters to us--something valued multi-dimensional by one party and supplied by one or more parties."

Net Exchange's imminent deal with 3PLEX.com, an ***exchange*** for trucking services, as well as its contemplated projects with bulk chemical or electric power concerns emphasize its larger mission: to create markets of tradable assets that allow participants to balance the benefits of long-term business planning with the market reactiveness accessible through secondary trading, including spot trading. 3PLEX is building a marketplace in which shippers' agents (third-party logistics suppliers, or "3PLS") ***exchange*** transport service contracts with trucking firms. Fitted with a ***Net Exchange*** trading mechanism, the 3PLEX marketplace will allow for the primary issue of spot and forward trucking contracts and for the retrading of these contracts as futures. Likewise, ***Net Exchange*** envisions a petrochemicals marketplace in which swaps between kerosene and gasoline or between other petroleum distillates can be used to secure a production plan more in line with a refinery's forward commitments and capacities while insuring the plan against risks outside the refinery's control.

"Once you set up a secondary market to trade the pieces of a forward agreement," concludes Polk, "businesses can contract for a much greater percentage of expected activity. B2B e-commerce can then move beyond its current limitations of off-loading excess inventory in the spot market."

PHOTO (COLOR): CHARLES POLK, PRINCIPAL OF ***NET EXCHANGE***

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